



Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Welcome to the **Small Business Tax Workshop**

Lesson 1



Agenda

- ◆ **Introduction**
- ◆ **Employer Identification Number**
- ◆ **Record Keeping**
- ◆ **Income Statement and Balance Sheet -- Accounting Methods**



Agenda (cont'd)

- ◆ **Types of Business Organizations**
- ◆ **Business Returns**
- ◆ **Net Profit or Loss**
- ◆ **Business Deductions and Credits**

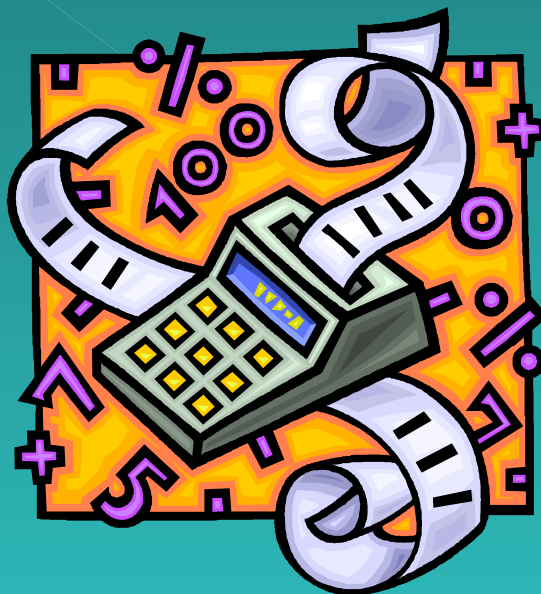


Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Employer Identification Number





Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Employer Identification Number

- ♦ **May be required to identify your business for filing with the IRS**

- ♦ **Apply for one by**
 - ♦ **logging on at www.irs.gov**
 - ♦ **phoning the IRS toll free number or**
 - ♦ **completing Form SS-4 -- Application for Federal Identification Number**



Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Record Keeping



**You must be able to substantiate income,
deductions and credits**



Record Keeping

Good records can help you:

- ◆ **Identify the source of receipts**
- ◆ **Prevent omission of deductible expenses**
- ◆ **Establish earnings for self-employment tax**
- ◆ **Explain items on the income tax return**



Special Rules For Record Keeping

For travel, transportation, entertainment, business gifts and certain other business property, you must be able to substantiate:

- ◆ the amount you are claiming**
- ◆ the time and the place of the expenditure**
- ◆ the business purpose**
- ◆ your business relationship to others involved**



Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

How Long to Keep Records?

**Keep your records as long as
their contents may be
material in the administration
of any Internal Revenue
Service law**



How Long is That?

Tax Returns & Supporting Records

The later of...

- 3 years after the return is due
- 3 years after the return is filed
- 2 years after the tax is paid

Employment Tax Records

The later of....

- 4 years after the return is due
- 4 years after the return is filed
- 4 years after the tax is paid



Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Records to Keep Indefinitely

- ◆ **Change in method of accounting**
- ◆ **Establish the basis of property**



Bookkeeping/Accounting Methods

- ♦ **Open a separate business bank account to maintain accounting efficiency**
- ♦ **Use the single or double entry system of bookkeeping**
- ♦ **On your return use the same accounting method you use to keep your records (cash or accrual)**



Bookkeeping Systems

Single Entry

- **Summaries of income and expense**
- **Simple**
- **Not a complete accounting system**

Double Entry

- **Built-in checks and balances**
- **Self-balancing**
- **More accurate**



Accounting Methods

Cash

- Report all income the year you receive it
- Usually deduct expenses in the year paid

Accrual

- Report income the year you earn it
- Deduct expenses the year you incur them



Cash Method for Small Businesses

- ◆ Gross receipts of \$10 million or less?
- ◆ Not manufacturing, wholesale, retail, mining, certain publishing, certain sound recording (unless principally service business or doing certain kinds of custom manufacturing)?
- ◆ If yes -- may be able to use cash method -- see
 - IR-2001-114
 - Notice 2001-76
 - Rev. Proc. 99-49
 - I.R.B. 1999-52



Computerized Record Keeping

- ◆ Many commercial software packages are available in retail stores that can help you with your business record keeping
- ◆ If you use a computerized system, you must be able to:
 - ◆ produce legible records from the system
 - ◆ to provide the information needed to
 - ◆ determine your correct tax liability



Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Income Statement & Balance Sheet





Definitions

Income Statement

- Income
- Expenses

Cash Flow Analysis

- Shows how money comes in and leaves your company

Balance Sheet

- Assets
- Liabilities
- Net Worth (Capital)



Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Types of Business Organizations



and Returns



Types of Business Organizations

- ♦ **Sole Proprietorship**
- ♦ **Partnership**
- ♦ **Limited Liability Partnership (LLP)**
- ♦ **Limited Liability Company (LLC)**
- ♦ **Corporations/S Corporations**



Sole Proprietorship

- ♦ **Easy to start**
- ♦ **Unlimited liability -- no distinction between the individual and the business**
- ♦ **Cannot be an employee of your own business**
- ♦ **Business income/losses reported on owner's Form 1040, Schedule C; self-employment tax on Schedule SE**



Partnerships

- ◆ **Written partnership agreement**
- ◆ **One partner can legally bind the partnership (and the other partner)**
- ◆ **Business income and losses reported on Form 1065; partner's share on Schedule K-1; profits taxed on the partners' returns**
- ◆ **Must have an Employer Identification Number (EIN)**



LLCs and LLPs

- ♦ **Separate legal entity formed by filing articles of organization with your State**
- ♦ **Not a federal tax entity-- generally treated as a sole-proprietor or partnership by IRS**
- ♦ **Limited liability for members**
- ♦ **Little legal precedent**



S Corporation

- ♦ **Corporation pays no tax on income -- taxed on the shareholders' returns**
- ♦ **Files Form 2553 and Form 1120S**
- ♦ **Active officers should receive wages and a W-2**
- ♦ **Limited personal liability with no double taxation**



Corporation

- ◆ **Separate legal entity that pays its own tax**
- ◆ **Files Form 1120 or Form 1120-A**
- ◆ **Limited liability**
- ◆ **Double taxation on dividends**
- ◆ **Can easily be changed to S-Corporation**
- ◆ **Subject to many state and federal controls**



Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Business Returns

- ◆ **Sole Proprietor -- Form 1040 Schedule C or C/EZ, Schedule SE and Form 1040ES**
- ◆ **Partnership - Form 1065**
- ◆ **S Corporation - Form 1120S**
- ◆ **Corporation- Form 1120 or 1120-A**

**SCHEDULE C**
(Form 1040)Department of the Treasury
Internal Revenue Service (99)**Profit or Loss From Business**

(Sole Proprietorship)

▶ Partnerships, joint ventures, etc., must file Form 1065 or Form 1065-B.

▶ Attach to Form 1040 or Form 1041. ▶ See instructions for Schedule C (Form 1040).

OMB No. 1545-0074

2001Attachment
Sequence No. **09**

Name of proprietor

John M. Martin

Social security number (SSN)

123 00 1234**A** Principal business or profession, including product or service (see page C-1 of the instructions)**Retail Furniture****B** Enter code from pages C-7 & 8**4 4 2 1 1 0****C** Business name. If no separate business name, leave blank.**John's Furniture Mart****D** Employer ID number (EIN), if any**1 0 0 1 0 1 0 1 0****E** Business address (including suite or room no.) ▶ **23 Valley St.**

City, town or post office, state, and ZIP code

Lake City, Maryland 21235**F** Accounting method: (1) ☐ Cash (2) ☒ Accrual (3) ☐ Other (specify) ▶**G** Did you "materially participate" in the operation of this business during 2001? If "No," see page C-2 for limit on losses ☒ Yes ☐ No**H** If you started or acquired this business during 2001, check here ☐**Part I Income**

1	Gross receipts or sales. Caution. If this income was reported to you on Form W-2 and the "Statutory employee" box on that form was checked, see page C-2 and check here <input type="checkbox"/>	1	48,000	00
2	Returns and allowances	2		
3	Subtract line 2 from line 1	3	48,000	00
4	Cost of goods sold (from line 42 on page 2)	4	28,200	00
5	Gross profit. Subtract line 4 from line 3	5	19,800	00
6	Other income, including Federal and state gasoline or fuel tax credit or refund (see page C-3)	6		
7	Gross income. Add lines 5 and 6	7	19,800	00

Part II Expenses. Enter expenses for business use of your home **only** on line 30.

8	Advertising	8	200	00	19		
9	Bad debts from sales or services (see page C-3)	9	150	00	20a		
10	Car and truck expenses (see page C-3)	10	2,000	00	20b		
11	Commissions and fees	11			21	300	00
12	Depletion	12			22		
13	Depreciation and section 179 expense deduction (not included in Part III) (see page C-3)	13	200	00	23	1,300	00
14	Employee benefit programs (other than on line 19)	14			24		
15	Insurance (other than health)	15	1,000	00	24a		
16	Interest:				24b		
a	Mortgage (paid to banks, etc.)	16a			24c		
b	Other	16b			24d	500	00
17	Legal and professional services	17			25		
18	Office expense	18	300	00	26	5,000	00
28	Total expenses before expenses for business use of home. Add lines 8 through 27 in columns	28			27	50	00
29	Tentative profit (loss). Subtract line 28 from line 7	29			28	11,000	00
30	Expenses for business use of your home. Attach Form 8829	30			29	8,800	00
31	Net profit or (loss). Subtract line 30 from line 29.	31			30		
	• If a profit, enter on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3.				31	8,800	00
	• If a loss, you must go to line 32.						
32	If you have a loss, check the box that describes your investment in this activity (see page C-6).						
	• If you checked 32a, enter the loss on Form 1040, line 12 , and also on Schedule SE, line 2 (statutory employees, see page C-5). Estates and trusts, enter on Form 1041, line 3.						
	• If you checked 32b, you must attach Form 6198 .						

32a ☒ All investment is at risk.
32b ☐ Some investment is not at risk.

33	Method(s) used to value closing inventory:	a <input checked="" type="checkbox"/> Cost	b <input type="checkbox"/> Lower of cost or market	c <input type="checkbox"/> Other (attach explanation)
34	Was there any change in determining quantities, costs, or valuations between opening and closing inventory? If "Yes," attach explanation			
				<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
35	Inventory at beginning of year. If different from last year's closing inventory, attach explanation	35	12,000	00
36	Purchases less cost of items withdrawn for personal use	36	26,000	00
37	Cost of labor. Do not include any amounts paid to yourself	37		
38	Materials and supplies	38		
39	Other costs	39		
40	Add lines 35 through 39	40	38,000	00
41	Inventory at end of year	41	9,800	00
42	Cost of goods sold. Subtract line 41 from line 40. Enter the result here and on page 1, line 4	42	28,200	00

43 When did you place your vehicle in service for business purposes? (month, day, year) ▶ 06 / 07 / 96

44 Of the total number of miles you drove your vehicle during 2001, enter the number of miles you used your vehicle for:

a Business 4,500 b Commuting 1,500 c Other 7,000

45 Do you (or your spouse) have another vehicle available for personal use? ☒ Yes ☐ No

46 Was your vehicle available for personal use during off-duty hours? ☒ Yes ☐ No

47a Do you have evidence to support your deduction? ☒ Yes ☐ No

b If "Yes," is the evidence written? ☒ Yes ☐ No

Dues and Publications		50	00
48	Total other expenses. Enter here and on page 1, line 27	48	50 00



Name of person with **self-employment** income (as shown on Form 1040)

John M. Martin

Social security number of person
with **self-employment** income ►

123 00 1234

Who Must File Schedule SE

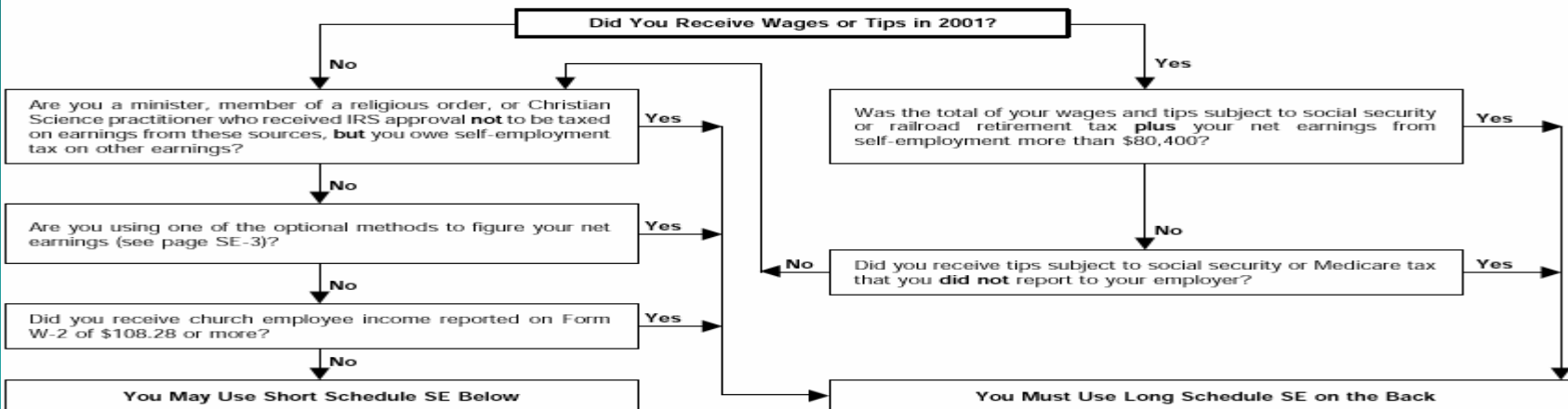
You must file Schedule SE if:

- You had net earnings from self-employment from **other than** church employee income (line 4 of Short Schedule SE or line 4c of Long Schedule SE) of \$400 or more **or**
- You had church employee income of \$108.28 or more. Income from services you performed as a minister or a member of a religious order **is not** church employee income. See page SE-1.

Note. Even if you had a loss or a small amount of income from self-employment, it may be to your benefit to file Schedule SE and use either "optional method" in Part II of Long Schedule SE. See page SE-3.

Exception. If your only self-employment income was from earnings as a minister, member of a religious order, or Christian Science practitioner **and** you filed Form 4361 and received IRS approval not to be taxed on those earnings, **do not** file Schedule SE. Instead, write "Exempt-Form 4361" on Form 1040, line 53.

May I Use Short Schedule SE or Must I Use Long Schedule SE?



Section A—Short Schedule SE. Caution. Read above to see if you can use Short Schedule SE.

1 Net farm profit or (loss) from Schedule F, line 36, and farm partnerships, Schedule K-1 (Form 1065), line 15a	1		
2 Net profit or (loss) from Schedule C, line 31; Schedule C-EZ, line 3; Schedule K-1 (Form 1065), line 15a (other than farming); and Schedule K-1 (Form 1065-B), box 9. Ministers and members of religious orders, see page SE-1 for amounts to report on this line. See page SE-2 for other income to report	2	8,800	
3 Combine lines 1 and 2	3	8,800	
4 Net earnings from self-employment. Multiply line 3 by 92.35% (.9235). If less than \$400, do not file this schedule; you do not owe self-employment tax ►	4	8,127	
5 Self-employment tax. If the amount on line 4 is: • \$80,400 or less, multiply line 4 by 15.3% (.153). Enter the result here and on Form 1040, line 53. • More than \$80,400, multiply line 4 by 2.9% (.029). Then, add \$9,969.60 to the result. Enter the total here and on Form 1040, line 53.	5	1,243	
6 Deduction for one-half of self-employment tax. Multiply line 5 by 50% (.5). Enter the result here and on Form 1040, line 27	6	622	00



Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Net Profit or Loss





Net Profit or Loss -- Definitions

Gross Receipts or Sales is income

- ♦ **that a business receives**
- ♦ **from the sale of its products and services**

Net Receipts/Sales =

Gross Receipt/Sales - Returns and Allowances



Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Net Profit & Loss Definitions (cont'd)

Cost of Goods Sold is the cost to a business to buy and make the product to be sold.

Cost of Goods Sold =

Beginning Inventory + Purchases, Labor, Materials and Other Costs - Ending Inventory

Gross Profit =

Net Receipts/Sales - Cost of Goods Sold



Net Profit & Loss Definitions (cont'd)

**Gross Income =
Gross Profit + Other Income**

Business Expenses are the

- **ordinary and necessary expenses**
- **incurred in the operation of the business**



Net Profit or Loss -- Definitions

Net Profit or Loss is the amount by which:

- gross income for a period
- is more (or less) than
- business expenses and depreciation
- for the same period

Net Profit or (Loss) =
Gross Income - Expenses



Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Business Deductions & Credits





Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Business Deductions & Credits

- **Deductions are subtracted from *income***
- **Credits are subtracted from *tax***



Travel and Transportation

Travel Expenses

- incurred in travelling away from home
- for business

Transportation Expenses

- incurred in the course of your business
- while you are not away from home
- while getting from one workplace to another
- not commuting



Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Entertainment and Gift Expenses

- **Must be ordinary and necessary**
- **Must be able to prove them**
- **See Pub. 463 Travel, Entertainment, Gift and Car Expenses for details**



Car Expenses

Standard Mileage Rate

Use the standard mileage rate for the current year

You can change from

the standard mileage rate to actual costs

Actual Costs

Use actual costs – prorate business/personal

You cannot change from....

actual costs to the standard mileage rate



Depreciation

Depreciation allows you to deduct the cost or other basis of some property over a number of years

Depreciable property does not include:

- **land**
- **inventory**
- **property placed into service and disposed of in the same year.**



Depreciation Requirements

The property must:

- **Be used in business or held for the production of income**
- **Have a determinable useful life longer than one year and**
- **Be something that wears out, decays, gets used up, becomes obsolete, etc.**



Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

MACRS

MACRS

Modified Accelerated Cost Recovery System

- ♦ **Most tangible property placed in service after 1986 is depreciated under MACRS**
- ♦ **See Publication 946**



Section 179

- ◆ **Deduct the cost of certain depreciable property in the year you purchase it and place it in service**
- ◆ **Deduct the total cost (up to the annual limit) in the first year**
- ◆ **Compute the deduction on Form 4562**
- ◆ **See Publication 946**



Other Kinds of Expenses

- ◆ **Retirement plan costs**
- ◆ **Percentage of the amount paid for medical insurance for yourself or your family**
- ◆ **Start-up costs incurred before you start your business operations**

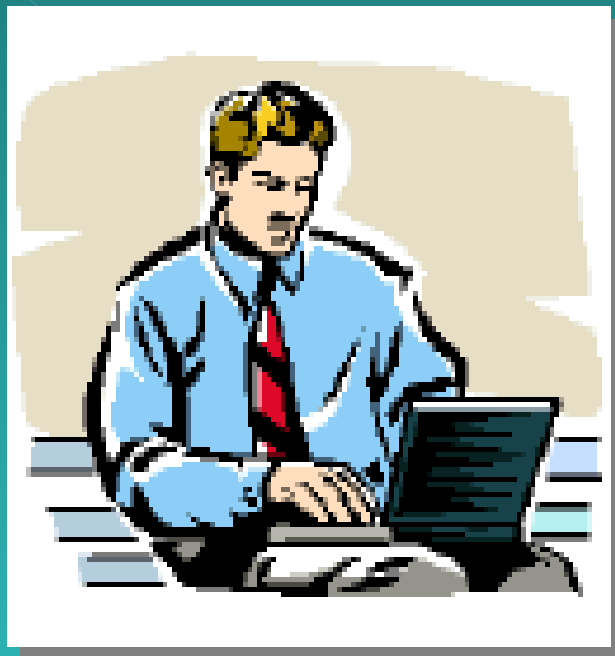


Internal Revenue Service

Small Business and Self-Employed

Taxpayer Education and Communication

Self-Employment Tax



and Estimated Taxes



Schedule SE -- Self-Employment Tax

- ◆ **Use the rate for the current year**
- ◆ **Provides Social Security coverage**
- ◆ **Subject to SE if Net Profit is \$400 or more**
- ◆ **Use the maximum earnings cut-off for the current year**



Schedule SE -- Multiple Businesses

If you have more than one business....

- ♦ **Use one Schedule SE**
- ♦ **Combine the profits and losses from**
- ♦ **All of your businesses**



Self-Employment/Social Security Tax

Self-Employment Tax

- **Self-employed people (sole proprietors)**
- **Partners in a partnership**

Social Security Tax

- **Withheld from employees' wages**
- **Matched by employer**

Social Security maximum applies to the person



Estimated Tax

- Estimate how much your tax liability will be for the current year
- Use Form 1040-ES (Estimated Tax for Individuals) worksheet to see if you will need to make estimated deposits
- You do not need to pay Estimated Tax if you reasonably expect your tax due to be less than \$1,000 (after withholding and other credits)



Internal Revenue Service

2002 Estimated Tax Worksheet (keep for your records)

1	Enter amount of adjusted gross income you expect in 2002 (see instructions)	1	50000
2	<ul style="list-style-type: none"> If you plan to itemize deductions, enter the estimated total of your itemized deductions. Caution: If line 1 above is over \$137,300 (\$68,650 if married filing separately), your deduction may be reduced. See Pub. 505 for details. If you do not plan to itemize deductions, see Standard Deduction on page 2 and enter your standard deduction here. 	2	7850
3	Subtract line 2 from line 1	3	42150
4	Exemptions. Multiply \$3,000 by the number of personal exemptions. If you can be claimed as a dependent on another person's 2002 return, your personal exemption is not allowed. Caution: See Pub. 505 to figure the amount to enter if line 1 above is over: \$206,000 if married filing jointly or qualifying widow(er); \$171,650 if head of household; \$137,300 if single; or \$103,000 if married filing separately.	4	9000
5	Subtract line 4 from line 3	5	33150
6	Tax. Figure your tax on the amount on line 5 by using the 2002 Tax Rate Schedules on page 2. Caution: If you have a net capital gain, see Pub. 505 to figure the tax	6	4373
7	Alternative minimum tax from Form 6251	7	
8	Add lines 6 and 7. Also include any tax from Forms 4972 and 8814 and any recapture of the education credits (see instructions)	8	4373
9	Credits (see instructions). Do not include any income tax withholding on this line	9	600
10	Subtract line 9 from line 8. If zero or less, enter -0-	10	3773
11	Self-employment tax (see instructions). Estimate of 2002 net earnings from self-employment \$.....; if \$84,900 or less , multiply the amount by 15.3%; if more than \$84,900 , multiply the amount by 2.9%, add \$10,527.60 to the result, and enter the total. Caution: If you also have wages subject to social security tax, see Pub. 505 to figure the amount to enter	11	6120
12	Other taxes (see instructions)	12	
13a	Add lines 10 through 12	13a	9893
b	Earned income credit, additional child tax credit, and credit from Form 4136	13b	
c	Total 2002 estimated tax. Subtract line 13b from line 13a. If zero or less, enter -0-	13c	9893
14a	Multiply line 13c by 90% (66⅔% for farmers and fishermen)	14a	8904
b	Enter the tax shown on your 2001 tax return (112% of that amount if you are not a farmer or fisherman and the adjusted gross income shown on line 34 of that return is more than \$150,000 or, if married filing separately for 2002, more than \$75,000)	14b	8000
c	Required annual payment to avoid a penalty. Enter the smaller of line 14a or 14b	14c	8000
Caution: Generally, if you do not prepay (through income tax withholding and estimated tax payments) at least the amount on line 14c, you may owe a penalty for not paying enough estimated tax. To avoid a penalty, make sure your estimate on line 13c is as accurate as possible. Even if you pay the required annual payment, you may still owe tax when you file your return. If you prefer, you may pay the amount shown on line 13c. For details, see Pub. 505.			
15	Income tax withheld and estimated to be withheld during 2002 (including income tax withholding on pensions, annuities, certain deferred income, etc.)	15	4500
16	Subtract line 15 from line 14c. (Note: If zero or less or line 13c minus line 15 is less than \$1,000, stop here. You are not required to make estimated tax payments.)	16	3500
17	If the first payment you are required to make is due April 15, 2002, enter ¼ of line 16 (minus any 2001 overpayment that you are applying to this installment) here, and on your payment voucher(s) if you are paying by check or money order. (Note: Household employers, see instructions.)	17	875



Internal Revenue Service
Small Business and Self-Employed
Taxpayer Education and Communication

Need More Information?

- ◆ **Publication 3207 -- Small Business Resource Guide CD**
- ◆ **Publication 463 -- Travel, Entertainment, Gift and Car**
- ◆ **Publication 534 -- Self Employment Tax**
- ◆ **Website: www.irs.gov**
- ◆ **1-800-829-4933 -- Business and Specialty Tax Line**